

Attention: Deficit Disorder

By Robert E. Rubin

13 May 2005

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THE United States has tremendous economic strengths but it also faces great challenges: the need to ensure national security; a newly competitive China and India; serious shortcomings in public education, basic research, infrastructure and other requisites for meeting that competition; and much else. An immediate and critical imperative is to redress fiscal imbalances.

Most pressing is the 10-year federal deficit, which most independent analysts project at \$4.5 trillion to \$5 trillion, assuming that the tax cuts passed in 2001 and 2003 are made permanent and that the alternative minimum tax is adjusted to avoid unintended effects on middle-income taxpayers. And while 10-year numbers can be highly unreliable, deficits are as likely to be higher as to be lower. Over the longer term, Social Security has a 75-year estimated deficit of \$4 trillion, while the different components of Medicare, including its new prescription drug benefit, represent a fiscal problem of roughly \$20 trillion.

Virtually all mainstream economists agree that, over time, sustained deficits crowd out private investment, increase interest rates, and reduce productivity and economic growth. But, far more dangerously, if markets here and abroad begin to fear long-term fiscal disarray and our related trade imbalances, those markets could then demand sharply higher interest rates for providing long-term debt capital and could put abrupt and sharp downward pressure on the dollar. These market effects, plus the adverse impact of continuing fiscal imbalances on business and consumer confidence, could seriously undermine our economy.

We have managed to avoid these market effects so far because private demand for capital has been relatively limited, and because the central banks of Japan, China and other countries have provided large inflows of foreign capital. A change in either of those circumstances, or simply a change of market psychology for whatever reason, could, however, turn these interest rate and currency risks into a reality.

The tough decisions needed on both spending and revenues will probably require some process whereby the president and leaders of the Senate and the House of Representatives and both parties assume joint responsibility for painful political choices. Tax revenues are approximately 16.5 percent of gross domestic product, the lowest level since 1960, and spending is roughly 20 percent. We must have serious spending discipline and entitlement reform -- though any entitlement reforms likely to be proposed would have little immediate effect.

But, as *BusinessWeek*, not an advocate of activist government, said in a recent editorial, "the deficit morass is due as much to a revenue shortfall as to excessive spending." (The 2001 and 2003 tax cuts, for example, are estimated to have a 75-year cost of \$11 trillion, almost three times the entire Social Security deficit.) And that shortfall is especially pressing given the rapid increases in entitlement costs and the need to finance national security, investments in education and infrastructure and other critical programs. At the same time, revenue-increasing measures must reverse the recent trend of disproportionately favoring upper-income taxpayers.

The first priority should be to tackle the 10-year fiscal imbalances, which would also be the best way to promote economic growth and minimize the risks I have outlined. Using structural measures to address the 10-year deficits would address our long-term imbalances as well.

For example, if the tax cuts for those earning above \$200,000 were repealed and the inheritance tax as reformed were continued rather than eliminated, the 10-year projected deficit would be reduced by roughly \$1.1 trillion, or almost 25 percent, and the 75-year fiscal reduction would be roughly \$3.9 trillion, or approximately equal to the Social Security shortfall. This course of action would be similar to the income tax increases that were combined with spending cuts in the 1993 deficit reduction program, which some predicted would lead to recession but which, instead, was followed by the longest economic expansion in our nation's history.

We should also begin a serious bipartisan process on Medicare to identify possible solutions and create public support for action, because doing so is absolutely key to our long-run fiscal health. Despite the focus in Washington today on Social Security, it is a smaller and less pressing problem, and our political system can bear only so much traffic at one time.

If we were to address Social Security now, whatever we do must not increase federal deficits and borrowing but instead must improve fiscal conditions and increase national savings in both the short and long terms. The proposal that the administration has embraced -- private accounts plus progressive price indexing of benefits -- would result in additional deficits and borrowing of more than \$1 trillion in the first 10 years, more than \$3 trillion in the second 10 years, and so on for roughly 50 years.

That's because this approach -- which would eliminate only about one-third of the projected 75-year Social Security deficit -- calls for private accounts that would involve immediate and large continuing costs while the savings begin only in the second decade and would grow slowly. While some estimate that after 50-plus years those savings will exceed costs on a cumulative basis, projected savings 50 years out will do nothing to offset the impact of increased deficits on interest rates. After all, if markets took into account 50-year projections of fiscal conditions, interest rates would already be through the roof.

Of course, we can continue to close our eyes and hope for the best. There's no way to predict whether that will work for another few months or for many more years. But the odds are extremely low that our fiscal imbalances will solve themselves, and we place ourselves at great peril by not facing these realities. Conversely, if we do address these challenges, then with our flexible labor and capital markets, and our historic embrace of change and willingness to take risks, our prospects over time should be very favorable.

Robert E. Rubin, Treasury secretary from 1995 to 1999, is a director of Citigroup.